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Finally, the discussion paper makes no proposals to deal with some of the difficulties surrounding internal and external relations. That is, perhaps, understandable. Under the present law an unincorporated association, not being a legal person, has no obligations: the default position is that office bearers or members will be personally liable on any contracts that they make. Once a new legal person is admitted, however, it is necessary to prescribe, even if only at a basic level, rules on its relationships, both internally (with members) and externally (with third parties). Rules regulating the insolvency of the association will also be required.¹⁸

D. DEVELOPMENT OF THE LAW OF PERSONS

The law of persons is core to private law. In other legal systems, particularly on the Continent, there are detailed and systematic regimes which have proved popular for pan-European associations. The proposed reform of the law of unincorporated associations highlights an unfortunate lacuna in Scots private law. The discussion paper and any subsequent reform of unincorporated associations cannot, perhaps, bridge that gap in its entirety. The law of associations is but part of a larger law of persons and it is in this context that the wider implications of legal personality ought to be considered: capacity, internal proceedings, external transactions, third party protection, insolvency. My own view is that there is, on balance, probably room for a new legal person for associations and that some, even minimal, formality should be required in order for an association to benefit from legal personality. But some basic principles are also needed for regulating the consequences of legal personality.

The discussion paper contains some valuable proposals on the law of associations. Of equal importance, however, it breaks the seals on a much neglected area of law, one too long hidden from view.

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Statutory Derivative Proceedings in Scotland: A Procedural Impasse?

Where a shareholder seeks a remedy on behalf of a company on the basis that a director has engaged in an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust, sections 265 to 269 of the Companies

¹⁸ An association can be sequestrated: Bankruptcy (Scotland) Act 1985 s 6(1)(c). It is also possible to petition the court for the appointment of a judicial factor over the affairs of the association: *Munro v Edinburgh & District Trades Council Social Club* 1989 GWD 6-120. Any reforms to the law of associations should retain this possibility.

Act 2006 stipulate that he or she must first apply to the court for leave to raise proceedings against that director or some other third party. *Wishart, Petitioner*¹ is the first application for leave considered by the Scottish courts where a member of a company has sought permission to be granted the right to raise such derivative proceedings against a director and a third party. In resolving to grant leave to the petitioner, Lord Glennie made some interesting observations about the minutiae of the application for leave procedure. In addition, the decision raises a number of central points which touch on the substantive law.

A. PRE-2007 LAW AND PROCEDURE

Sections 265 to 269 of the Companies Act 2006 came into force on 1 October 2007.² Prior to that date, whilst the law of Scotland was not particularly well-developed, it was clear that a member had the right to raise an action at common law against a director or third party in order to obtain a remedy on behalf of the company.³ In terms of *Barrett v Duckett*⁴ and Rule 19.9(3) of the Civil Procedure Rules, where a plaintiff raised a derivative action in the English courts, there was an obligation to make a preliminary application for leave to continue within a relatively short period of instituting such proceedings. The purpose of this process was to weed out baseless or vexatious claims. An attempt to import the English “permission to continue” procedure was rejected by Lord Eassie in *Wilson v Inverness Retail and Business Park Ltd*.⁵ His Lordship took the view that a preliminary challenge to the claim could be made by the director or company on the basis of a preliminary plea to the competency of the action or on the basis of a lack of title to sue.⁶

In the event, section 266 of the Companies Act 2006 introduced a particular form of requirement for leave into Scots law along the lines of the English model which had been rejected by Lord Eassie in *Wilson*. Thus, an application for leave to raise derivative proceedings must first be made and considered by the court in terms of sections 266 and 268 of the Act. On the face of it, therefore, the Act suggests the existence of two separate proceedings, the first being the application for leave proceedings and the second being the substantive derivative proceedings. This can

1 [2009] CSOH 20, 2009 SLT 376.

2 Companies Act 2006 (Commencement No 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007, SI 2007/2194 art 2(1)(e).

3 *Orr v Glasgow etc Railway Co* (1860) 3 Macq 799; *Lee v Crawford* (1890) 17 R 1094; *Hannay v Muir* (1898) 1 F 306; *Anderson v Hogg* 2000 SLT 634; *Wilson & Docherty v Inverness Retail & Business Park Ltd & Shaw* 2003 SLT 301; A A Paterson “The derivative action in Scotland” 1982 SLT (News) 205; D Cabrelli, “Derivative actions: part of the minority shareholder’s ‘forensic arsenal’ in Scotland?” 2003 SLT (News) 73; R Goddard, “Shareholder remedies in Scotland: *Anderson v Hogg*” (2003) 7 EdinLR 93.

4 [1995] BCC 362 at 367 per Peter Gibson LJ.

5 2003 SLT 301.

6 *Wilson v Inverness Retail and Business Park Ltd* 2003 SLT 301 at para 22. One might conjecture that Lord Eassie’s approach is attributable to the fact that the issues of competency or title to sue are matters of substantive, rather than procedural, law in Scotland (unlike in England). See Law Commission, Report on *Shareholder Remedies* (Law Com No 246, 1997) 118 at para 3; Explanatory Notes to the Companies Act 2006 para 488.

be contrasted with English law where the application for leave is an integral, albeit incidental and preliminary, part of the substantive derivative claim itself.⁷

B. THE APPLICATION FOR LEAVE PROCEEDINGS

Section 266 envisages a two-stage application for leave process. First, in terms of section 266(2), the application for leave must be lodged with the court, specifying the cause of action and summarising the facts on which the derivative proceedings are to be based. If the court is not satisfied *ex parte* (on the basis of evidence produced to substantiate the allegations narrated in the application) that there is no *prima facie* case which has been disclosed,⁸ section 266(4) directs that the applicant is entitled to serve the application on the company (rather than the prospective defenders in future derivative proceedings)⁹ and the court may make an order requiring evidence to be produced by the company. Furthermore, the court has the power to adjourn the proceedings on the application to enable the evidence to be obtained¹⁰ and the company is entitled to take part in further proceedings on the application. The application thus proceeds to the second stage which entails a hearing involving the member and the company. At this point, the court must consider certain mandatory and discretionary criteria which are specified in section 268(1), (2) and (3) of the Act and grant, refuse or adjourn the application.

Section 266 engenders a number of specific difficulties from a procedural perspective. The first relates to the nature of the originating process to be followed in making an application for leave. On this point, the text of section 266 is distinctly unilluminating. This is compounded by the fact that no specific Rules of Court have been promulgated in Scotland. What *Wishart* tells us is that the correct originating process for an application for leave is by petition to the Outer House.¹¹ However, Lord Glennie was particularly critical of the schema envisaged in terms of the Act, since it necessarily entails two separate proceedings, namely the application for leave proceedings (itself divided into *ex parte* and *inter partes* phases) and the substantive derivative proceedings. Therefore, he suggested that the Rules Committee promulgate Rules of Court whereby machinery is prescribed which directs that an application for leave under section 266 of the Act proceed by note or some other proceeding ancillary to the proposed derivative proceedings itself.¹² This, he opined, would ensure symmetry between the procedures in Scotland and England.

A second difficulty concerns the nature and quality of the evidence to be produced at the initial *ex parte* stage. Section 266 is silent on this point, but Lord Glennie opined

⁷ Companies Act 2006 s 261(1).

⁸ *Wishart* at para 17. The double negative reflects the wording of s 266(3) and (4).

⁹ See the discussion in *Wishart* at para 18.

¹⁰ Presumably to enable a meeting of shareholders to be convened by the board of directors of the company in order to unearth the general meeting's position on the director's alleged breach or negligence, i.e. to determine whether the general meeting is minded to ratify the director's act or omission.

¹¹ Para 17.

¹² Para 40.

that, as a general rule,¹³ the court would examine the evidence in the absence of a hearing. In order to assist the court, “it would be helpful . . . if a draft of the summons in the proposed action were lodged in the petition process”.¹⁴

The third and perhaps most pressing issue concerning section 266 relates to the manner and level of engagement which the court is bound to make with the substantive merits of the underlying derivative claim. The potential danger is that if it is intended that the court engage with the full merits of the claim at the *inter partes* phase, this would entail a “dress rehearsal”, leading to wasteful duplication of evidence and costs since the same points would necessarily be revisited at the full hearing in the derivative proceedings. Again, section 266(4) and (5) has nothing to say concerning the requisite degree of enquiry to be made by the court. However, section 268 identifies the mandatory and discretionary criteria to be applied by the court in determining whether leave should be granted at the *inter partes* stage. On the face of it, as noted by Lord Glennie, the matters to be considered are not of the sort which demand extensive evidence or consideration of the merits of the underlying action. They either entail the application of legal propositions to ascertainable facts, are questions of law, or are questions of fact themselves. Only the reference in section 268(2)(a) to an evaluation of the “good faith” of the member in pursuing the action has the potential for raising difficult evidential questions. With regard to the “good faith” criterion, Lord Glennie was of the view that it would be perfectly possible to deal with this matter on the basis of the averments in the petition and any evidence lodged in support, thus discounting the need for consideration of extensive evidence. On balance, the company could be protected by enabling it to lodge affidavits in process without the need for a lengthy hearing of the merits on full evidence, thus restricting the factual enquiry at the application stage to a “light touch” one-day hearing.¹⁵ Lord Glennie reasoned that there were two rationales for his approach. The first centred on the primary objective of the *inter partes* phase of the application for leave process, which is to enable the courts to weed out unfounded, unmeritorious and vexatious derivative proceedings.¹⁶ The second rationale is posited on concerns regarding prescription. If a hearing on the merits were envisaged, this would be problematic for the member in raising the derivative proceedings, since any delay in the final determination of the *inter partes* stage of the application for leave to commence the derivative proceedings would obviously delay and might ultimately preclude the progression of the derivative action itself.¹⁷

C. SUBSTANTIVE GUIDANCE

Lord Glennie also provided substantive guidance on what criteria ought to satisfy the court of a *prima facie* case at the *ex parte* stage in terms of section 266(3) of

13 However, he made the point that it was possible for a hearing to be starred if the court so wished:
para 17.

14 Para 17.

15 Para 30.

16 Paras 26 and 30. See also para 495 of the Explanatory Notes to the Act.

17 Para 25.

the Act. He noted that the interaction between sections 266(3) and 265(3) requires the court to be satisfied that there has been a relevant act or omission by one or more directors of the company. However, Lord Glennie went further and opined that the applicant must establish wrongdoer control, i.e. that the wrongdoer director has majority control which is or would be exercised to prevent a proper action being brought against the wrongdoer.¹⁸ This seems misconceived. During the Act's progress through Parliament, the Solicitor-General (Mike O'Brien MP) stated that:¹⁹

We do not want the claimant to have to show "wrongdoer control" – that is, to show that the company is controlled by the directors whom the claimant believes to have acted in breach of their duties – as that might make it impossible for a derivative claim to be brought successfully by a member of a widely held company, including almost all major quoted companies.

In a recent English decision, *Franbar Holdings Ltd. v Patel*,²⁰ it was implicit in William Trower QC's judgment that the issue of wrongdoer control must be taken into account at the *inter partes* (rather than the *ex parte*) stage in evaluating whether the director's act or omission was capable of ratification in terms of section 263(3)(c)²¹ of the Act.²² This approach seems preferable.

In its final report on *Shareholder Remedies*, the Law Commission declared that "[good faith] is a concept with which the Scottish courts are very familiar" and recommended that "good faith" should not be defined.²³ In *Wishart*, Lord Glennie conveniently set out what the applicant must show in order to evince his or her good faith in terms of section 268(2)(a). There are two factors to consider in this context: whether the applicant for leave honestly believes any cause of action exists and has a reasonable prospect of success, and whether the applicant is seeking to bring the derivative suit for such a collateral purpose as would amount to an abuse of process. However, Lord Glennie sounded two particular caveats: first, that these two factors would in most, though not all, cases entirely overlap, and secondly, that the two-prong test is not intended to be prescriptive.²⁴ This seems entirely reasonable since the court ought to be entitled to refuse the application for leave where the applicant's motivations are grounded in ulterior factors. Moreover, this proposition links in well with the "gateway" or "threshold" rationale which underpins the application for leave process, i.e. that unmeritorious claims should be weeded out.

Finally, despite the absence of Rules of Court specifically empowering the court to do so, but noting that section 266(5)(a) enabled the court to grant such order "as it thinks fit" once the hearing at the *inter partes* stage has been concluded, Lord Glennie was prepared to accept that the court had jurisdiction to grant a *Wallersteiner*²⁵

18 Para 27.

19 HC Deb 17 Oct 2006, col 832.

20 [2008] EWHC 1534 (Ch), [2008] BCC 885.

21 Section 268(2)(c) is the equivalent provision which applies to Scotland.

22 *Franbar Holdings Ltd v Patel* [2008] BCC 885 at 897-898.

23 Law Commission, Report on *Shareholder Remedies* (Law Com No 246, 1997) para 52.

24 *Wishart* at para 33.

25 Named after the case of *Wallersteiner v Moir* (No 2) [1975] QB 373.

order.²⁶ Such an order is to the effect that the petitioning shareholder's expenses in the forthcoming derivative proceedings be met by the company. Lord Glennie ought to be commended for adopting this pragmatic stance, since it is possible for such orders to be made under English procedure and it would be somewhat surprising if it had been ruled that the procedures in England and Scotland ought to diverge.²⁷ In addition, if Lord Glennie had ruled that no such jurisdiction existed, this would have acted as a material disincentive for shareholders to use the new statutory derivative proceedings.

D. CONCLUSION

Although Lord Glennie's judgment provides helpful clarification in respect of a number of procedural and substantive uncertainties raised by sections 265 to 269 of the Act, one might be excused for wondering why an aggrieved minority shareholder would be minded to raise statutory derivative proceedings in preference to a section 994 unfair prejudice petition.²⁸ Whilst it may seem counter-intuitive, it may make perfect sense for an aggrieved shareholder in a private company to proceed to secure relief by raising derivative proceedings. Such proceedings may be the only practical recourse available to a minority shareholder since, in present economic conditions, the majority may be in no position to secure external funding to finance a buy-out of the former's shares pursuant to an order under section 996. Another point is that the nature of the company may not lend itself to a share buy-out, as for example in the case of a property holding company where the break up of company assets would be extremely difficult and generally undesirable. A final point in favour of raising derivative proceedings is the availability of a *Wallersteiner* order in terms of Lord Glennie's judgment in *Wishart*, i.e. a right of indemnity from the company in respect of the shareholder's costs. This is a particularly useful device, bearing in mind that first, Scots law was formerly particularly unclear on this point,²⁹ and secondly, that the court has no jurisdiction to grant such an expenses indemnity order under section 994.³⁰

Lord Glennie's decision has been appealed. It is to be hoped that the Inner House will endorse the majority of Lord Glennie's points of clarification and so infuse vitality into the statutory derivative proceedings.

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²⁶ *Wishart* at para 38.

²⁷ The Law Commissions were specifically minded to avoid such an outcome, see Report on *Shareholder Remedies* (n 6) 118 at para. 4.

²⁸ Section 994 enables a shareholder to obtain a personal remedy where the affairs of the company have been conducted by the majority or the directors in an unfairly prejudicial manner, whereas successful derivative proceedings result in a remedy for the company. The usual remedy in a successful unfair prejudice petition is for the court to order the shares of the minority to be bought out.

²⁹ Law Commission, Consultation Paper on *Shareholder Remedies* (Law Com CP No 142, 1996) 51, para 6.10 at n 29, and Report on *Shareholder Remedies* (n 6) 136 at para 71.

³⁰ *Re Sherborne Park Residents Co Ltd* [1987] BCLC 82 at 85 per Hoffmann J.